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Risk Management Committee and Disclosure of Hedging Activities Information among Malaysian Listed Companies

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Abstract

This paper examines the relationship between Risk Management Committee (RMC) characteristics and the extent of hedging activities disclosure within the annual reports of the Malaysian listed companies. In particular, relationships are tested on RMC size, independence, RMC meeting, RMC gender diversity and RMC training. Our regression analysis shows that RMC independence significantly and negatively influences the extent of hedging activities information disclosure, while RMC meeting positively influences the disclosure. The implications of these findings are discussed.

Keywords: Financial Instruments, Hedging Activities, Disclosure Index, Risk Management Committee.

INTRODUCTION

The introduction of IFRS 7 (Financial Instruments: Disclosure) is argued to be able to enhance the disclosure of derivatives and hedging activities information. On the Malaysian scene, FRS 7 (Financial Instruments: Disclosures), now MFRS 7, has been made effective from Jan 1, 2010. MFRS 7 which is based on IFRS 7, segregates IAS 32 (the Malaysian equivalent of FRS 132: Financial Instruments: Disclosure and Presentation). It provides an overview of the entity's use of derivatives and the exposure to risks they create. While MFRS 7 has just been applied by business entities in Malaysia, several studies in other countries have raised concerns regarding the extent and quality of the derivatives disclosure provided by companies in meeting this accounting standard [see 1, 2, 3 and 4] particularly on the hedging activities information. It was claimed that the derivatives disclosure was less useful and subject to management discretion [see 5, 6, and 7]. Moreover, since hedge accounting is optional, companies may use their discretion not to report the use of derivatives for hedging activities5. Several studies

provide evidence that companies avoid full compliance in disclosing their hedging activities information in annual reports [see, 1, 4, 5]. In this respect, some studies propose that one of the important elements that should exist in a company for a better transparency of derivatives and hedging activities disclosure is the establishment of Risk Management Committees (RMCs) [see 1,6,9]. Nevertheless, there are mixed empirical evidences justifying the existence of RMCs and the degree of transparency and quality of financial instruments disclosure, particularly on the derivatives and hedging activities information1, 8, 9. Thus, it is the objective of this study to examine the effectiveness of RMCs. Different from earlier studies, this study focuses on the characteristics of RMCs as a proxy for its effectiveness (i.e. size, independence, meeting, diversity and training). This paper is outlined as follows: Section 2 highlights related Malaysian studies on financial instruments disclosure. Section 3 shows the hypotheses of this study. Section 4 explains the methodology and Section 5 presents the results. Lastly, Section 6 concludes this paper.

MALAYSIAN RELATED STUDIES

In Malaysia, limited studies were found to address the disclosure of financial instruments information [see 6, 8, 15, 18]. The earliest traceable study that provides evidence of the extent of financial instruments disclosure (including derivatives) only relates to two specific company characteristics, which are company size, and the level of foreign activities. Moreover, the study also claims that the level of disclosure of derivatives before the issuance of the accounting standard is low, possibly due to the lack of control mechanisms in Malaysia. In addition, the results of the study has been argued to be bias since the disclosure is voluntary in nature and certain companies might have different capabilities in terms of money and human resources. In another study6, it was reported that the existence of the risk management committee (RMC), company size, and profitability are associated with high quality financial instruments information. Although it provides some meaningful insights, the study is still not conclusive as the results may be outdated. The study was conducted in the period before the revised accounting standard for financial instruments was issued. Moreover, in recent studies [8],[18], it is found that RMCs has no relationship with the extent of derivatives disclosure while audit committees have more influence on the extent of the disclosure[18]. It is argued that this may be due to the lack of independence and effectiveness of RMCs.

HYPOTHESES

This study uses agency theory and resource dependency theory as underpinning theories to develop the hypotheses [see, 10, 11, 12]. The following hypotheses have been developed in this study:

- **H1:** The extent of hedging activities information disclosure is positively associated with RMC size.
- **H2:** The extent of hedging activities information is positively associated with RMC independence
- **H3:** The extent of hedging activities information is positively associated with RMC meeting.
- **H4:** The extent of hedging activities information is positively associated with the proportion of female directors on RMCs.
- **H5:** The extent of hedging activities information is positively associated with the number of risk management training attended by RMC members.

RESEARCH METHODOLOGY

This study uses secondary data, collected from two separate sources which are DataStream and the Malaysian listed companies' annual report, downloaded from the Bursa Malaysia's website. Financial data (i.e. ROA, total assets and leverage) are obtained from the Datastream. Information on the risk management committees is gathered from the board of directors' profile and risk management report section in the annual reports. In the case where RMC is a sub-committee of the audit committee (AC), this study selects the RMC characteristics based on AC characteristics. It is assumed valid as the establishment of an RMC through AC performs similar roles. Our sample comprises 300 largest companies listed on the Main Board of Bursa Malaysia in 2013. Companies that are in the sectors such as banking, insurance, trust, REITs and closed-end funds are omitted from the sample due to additional regulations imposed on them[6,13]. This sample size is assumed sufficient because many previous financial instrument disclosure studies had shown that there is no specific rule that specifies the sample size [See, 1, 2, 8]. The 2013 financial year has been chosen because it is the third year MFRS 7 has been fully adopted. The time is sufficient for companies to adopt the standard. Nevertheless, we eventually ended up with 117 companies since not all the sampled companies use derivatives to evade their financial risk exposure and establish an RMC.

The dependent variable of this study is the extent of hedging activities information disclosure (EHAD). To measure this variable, a disclosure index was prepared, based on 32 mandatory and discretionary disclosure items. The score is calculated by adding up all items disclosed divided by the maximum number of possible scores. Mandated disclosures on derivatives and hedge activities information are directly derived from MFRS 7 (Financial Instruments: Disclosure). Specifically, such disclosure items include all those in the hedge accounting section of MFRS 7 (paragraph 22-24) and other related hedging activities disclosure requirements. For voluntary hedging activities information, the disclosure items are extracted and composed from the accounting literature. In order to avoid unsystematic evaluation processes and the reliability of the design disclosure checklist, we further cross-check such disclosure items with the PWC's IFRS Presentation and Disclosure Checklist 2012. The PWC's disclosure checklist is used because it presents a practically tested auditing tool where this study assumed that high assurance on disclosure of hedging activities information can be counted on. Table 1 shows the measurements of the all the RMC characteristics and control variables.

Table.1. Measurement of Explanatory Variables

Variable Acronym	Definition	Measurement
RSIZE	RMC Size	Number of RMC members
RINDE	RMC Independence	Proportion of independent non-executive members on the RMC
RMEET	RMC meeting	Number of RMC meetings during the financial year
RDIVER	RMC Gender Diversity	Proportion of female members on the RMC.
RTRAIN	RMC Training	Number of types of risk management training attended by RMC members
CSIZE	Company Size	Natural log of total assets
PROF	Profitability	Return on assets (ROA)
LEV	Leverage	Debt to total assets ratio
AUDITOR	Auditor Quality	Dichotomous variable 1 if audited by Big 4, 0 otherwise

To test the relationship between RMC characteristics and the extent of hedging activities information disclosure, a multiple linear regression is performed. The regression model is constructed as follows:

$$\mathbf{EHAD}_i = \alpha+\beta_1 RSIZE_i + \beta_2 RINDE_i + \beta_3 RMEET_i + \beta_4 RDIVER_i + \beta_5 RTRAIN_i + \beta_6 CSIZE_i + \beta_7 PROF_i + \beta_8 LEV_i + \beta_9 AUDITOR_i + \varepsilon_i$$

RESULTS AND DISCUSSIONS

Descriptive statistics for the variables is shown in Table 2. As evidenced from the table, there are variations in the disclosure of hedging activities information between sampled companies. The mean score for the extent of hedging activities disclosure is 0.7729 with a minimum score of 0.44 and a maximum score of 0.98. The average of RSIZE is 3.83 members (approximately 4), exceeding the minimum demand of three members in AC. The largest RMC comprises 9 members while the smallest comprises 2 members. The mean score of 0.7082 for RINDE indicates that on average, the number of independent directors in RMCs is greater than non-independent directors. In other words, RMCs in Malaysia are more likely to be independent, although it is voluntary in nature. Some of the RMCs comprise of all independent directors, while some have no independent director. On average, RMCs conduct their meetings 4 times a year; however, there are RMCs that did not conduct any RMC meeting. The highest number of meetings of the sampled companies is 12 times. The mean RDIVER of 0.32 shows that on average women represent 32 percent of the RMC.

Table.2. Descriptive Statistics

	Mean	Std. Deviation	Min.	Max.
EHAD	.7729	.15226	.44	.98
RSIZE	3.83	1.132	2	9
RINDE	.7082	.34945	0.00	1
RMEET	4.01	1.887	0	12
RDIVER	.32	.467	0.00	0.71
RTRAIN	2.44	1.214	0	6
CSIZE	14.8927	1.43135	12.43	18.41
PROF	2.3559	1.16062	0.49	7.76
LEV	4.8722	1.70329	0.10	7.65
AUDITOR	.84	.370	0	1

Table 3 presents the outcomes of the regression analysis between the disclosure of hedging activities information, RMC characteristics and control variables. The Variance Inflation Factor (VIF) statistics indicate that multicollinearity does not exist in the model as the values are less than 10. The model explains 21.1 percent of the variation in the level of hedging activities information disclosure, which is relatively low. Although the adjusted R2 is low, the finding is consistent with those of the previous studies, which pointed out that the low R2 is

common in corporate governance researches [see, 1, 15, 16]. We provide some insights on the association between EHAD and each of RINDE, RMEET, CSIZE and LEV. Table 3 shows that RINDE (t value = -2.497) has a significant and negative relationship with the extent of hedging activities disclosure, at $p < 0.01$. This finding indicates that independent directors in RMCs are not concerned with the extent of hedging activities information disclosure. A possible explanation is that independent directors do not contribute their experience as well as their skills and knowledge towards increasing the information on hedging activities [see 15, 16]. As argued in the literature, independent directors do not play an active role in supervising the management as the directors usually rely on management for information due to their busy schedule and commitment towards other activities. Another possible explanation is that the independent directors may have a relationship with the management, making way for their long period of experience on the boards. As a result, their decision making may have been influenced by the management since their appointment to the board is merely due to their relationship with the company. Results from Table 3 also show that RMEET has a significant and positive relationship with the extent of hedging activities information disclosure. This indicates that frequent meetings by RMCs are more likely to be related to high level of hedging activities disclosure. However, RSIZE, RDIVER, RTRAIN and REXPERT are found insignificant.

Table.3. Regression Results

Model	Predicted Sign	Coeff.	SE	t	Sig.	VIF
(Constant)		0.001	0.144	0.009	.993	
RSIZE	+	0.013	0.012	1.071	.286	1.138
RINDE	+	-0.099	0.039	-2.497	.014***	1.204
RMEET	+	0.020	0.007	2.841	.005***	1.142
RDIVER	+	-0.017	0.028	-.617	.539	1.072
RTRAIN	+	-0.013	0.011	-1.101	.274	1.228
CSIZE		0.041	0.010	4.274	.000***	1.183
PROF		0.014	0.013	1.024	.308	1.102
LEV		0.017	0.008	2.168	.032**	1.147
AUDITOR		0.027	0.035	0.780	.437	1.047
Adjusted R^2	0.211	P value	0.000			
F statistic	4.448	N	117			

****Significant at the 0.01 level, **significant at the 0.05 level, *significant at the 0.1 level.*

Consistent with prior research, company size was also found to be positively related to the extent of hedging activities information disclosure [see, 1, 2, 3, 6, 15, 16]. Based on agency theory, large firms incur lower information processing costs, but higher political costs, thereby encouraging them to disclose greater information. With regard to audit quality, this study found that hedging activities disclosure is not significantly influenced by Big 4 audit firms6. PROF is found not to be related to EHAD. One factor that could explain the finding is the impact of the global systemic economic crisis (i.e. Eurozone debt and world petroleum price fluctuations). The recovery planning after the crisis that occurred during the period may affect the performance of the sampled companies. However, the prediction that the disclosure of hedging activities information is positively related to financial risks (i.e. leverage) is supported at $p < 0.05$. The result is consistent with some of the previous studies. The extent of disclosure increases with increasing financial risks, where companies with higher leverage increase disclosure to reduce potential agency costs associated with external funding and their asset replacement16.

CONCLUSION

The objective of this study is to examine the influence of risk management committee characteristics (i.e. RMC size, RMC independence, RMC meeting, RMC gender diversity and RMC training) to the extent of hedging activities information disclosures in the annual reports of Malaysian listed companies. The analysis shows that the RMC characteristics (i.e. RINDE, RMEET) have some significant bearing in influencing the extent of hedging activities information disclosure in Malaysia. Intrinsically, this finding may provide some meaningful insights to the regulator, policy makers and researchers, especially in incorporating RMCs as part of the corporate governance mechanisms. It is not just the existence of RMC, but their effectiveness is something that needs to be emphasized.

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